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SUBJECT: NICARAGUA: FINANCIAL SECTOR UPDATE

REF: A) MANAGUA 1771, B) MANAGUA 1719, C) MANAGUA 1672, D) MANAGUA 464, E) 06 MANAGUA 2463

¶1. (U) Summary: Despite President Ortega's increasingly anti-capitalist rhetoric, the GON has not significantly changed economic policy vis a vis the previous administration. As a result, the financial sector has remained stable. The exchange rate continues on its 5% crawling peg and foreign reserves keep growing to record levels. Interest rates for deposits and loans have risen, but are still comparable to other Central American countries. Yields for GON debt have been lower than expected. The recently negotiated PRGF with the IMF should go a long way toward ensuring continued stability for the sector. End summary.

Exchange Rate

¶2. (U) Nicaragua has managed its exchange rates with a crawling peg against the U.S. dollar since January 1993. The peg began with a 5% annual devaluation and quickly reached a high of 12% by November ¶1993. In 2004, the rate was reduced to its current rate of 5%. The recently concluded Poverty Reduction and Growth Facility (PRGF) negotiations with the IMF left the exchange rate at 5% annual devaluation for the next three years (Ref A). Some economists argue that given Nicaragua's ambitiously low inflation targets, the crawl should be cut to 3%. GON and IMF analysts believe, however, that such a reduction would inflate the cordoba and predjudice the growing export sector. (Note: The IMF also feels that the lower inflation target of 7% for 2007 will not be met. End note.) The GON cites the less than 1% difference between the official rate of 18.5 cordobas to the dollar and the current parallel market rate as evidence that the 5% devaluation is correct and sustainable.

Reserves

¶3. (U) Nicaragua continues to pile up record high reserves. At the end of 2006, Nicaragua had $472.2 million in adjusted net reserves, a record which was easily bested by the July 31 level of $586.8 million. Consistency in fiscal and monetary policy, assistance from donors, and increased trade and tourism has contributed to this result. Indeed, the GON has already achieved the 2007 PRGF reserves target of a $60 million increase. Under the agreement, the GON promised to increase adjusted net reserves by an additional $70 million in 2008, $80 million in 2009, and $90 million in 2010. As of June, adjusted net reserves cover about two months of imports. (Note: Ref D cites net international reserves of $859 million for ¶2006. The IMF tracks adjusted net reserves, which subtracts legally required foreign currency bank deposits from net reserves. End note.)

Interest Rates

¶4. (U) Nicaraguan interest rates, while high compared to U.S. levels, are comparable to those in neighboring countries.

-- Deposits: For cordoba deposits, the weighted average interest rate in June was 7.22%, a 33.7% increase since June 2006. For dollar deposits, the rate was 5.67%, a 23.7% increase since the same time last year.

-- Loans: The weighted average rate for cordoba loans in June was 16.33%, a 23% increase from the June 2006 rate of 13.27%. Dollar denominated loans (about 83% of the formal loan market), have carried more stable interest rates. In June, the weighted average interest rate was 11.46%, a 7.7% increase from the June 2006 rate of 10.64%. Personal consumer loans are the priciest, followed by home loans and commercial loans.

-- Government bonds: Interest rates for Nicaraguan Central Bank (BCN) short-term bonds (3 and 6 months) now range around 9%, a small decrease since last year. Recent issuances of 12-month paper by the GON (Ministry of Finance) sold for a yield of 9.8% (Ref B). Because this is the first GON debt issuance in two years, there is little basis for historical comparison. Our U.S. Treasury Advisor indicates, however, that the rates received were slightly below what was expected, i.e. 10-11%.

Notes:
-- Cordoba loan rates reached a high of 17.85% in September 2006, right before the elections.
-- While at least 5% of the increase in cordoba loans and deposits reflects the yearly currency devaluation, some of the increases reflect the rise in international interest rates.
-- About 300 registered microfinance institutions manage USD 400 million in small loans, which carry average interest rates between 20-40%. We did not include those rates in the calculations above.

The Banks

¶5. (U) The Nicaraguan banking system continues to post strong numbers after having recovered from its pre-election dip in deposits (Ref E). In February 2007, deposits surpassed the 2006 peak of USD 2.1 billion, and have continued to grow. Savings in dollars accounts for around 60% of bank deposits, a percentage that has remained stable for the past 10 years. BCN raised legal reserves for deposits in June 2006 from 16.25% to 19.25% to help cover any possible drop in deposits during the election period. Banks expect the BCN to return this rate to 16.25% by the end of 2007.

¶6. (U) Bank representatives do note that deposits continue to be predominantly short-term (2-3 month Certificates of Deposit) with only GON institutions investing in longer term CDs. A concomitant drop in borrowing has resulted in an increase in liquidity for banks. The GON hopes to take advantage of this excess liquidity by offering banks the opportunity to purchase one- and three-year bonds during fall auctions.

Comment

¶7. (U) In spite of the mixed signals from the GON (Ortega's socialist rhetoric vs. IMF agreement) and the lack of any coherent economic policy or message, the country's financial sector remains stable. The lack of a gap between the rate on the street and the official rate indicates that the crawl is about right. International reserves are adequate, covering more than three months of imports, and bankers are not expressing serious concerns. The recently negotiated PRGF with the IMF should go a long way toward ensuring continued stability for the sector. End comment.

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